DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — $75 Annually

Registered with the Securities Exchange Commission

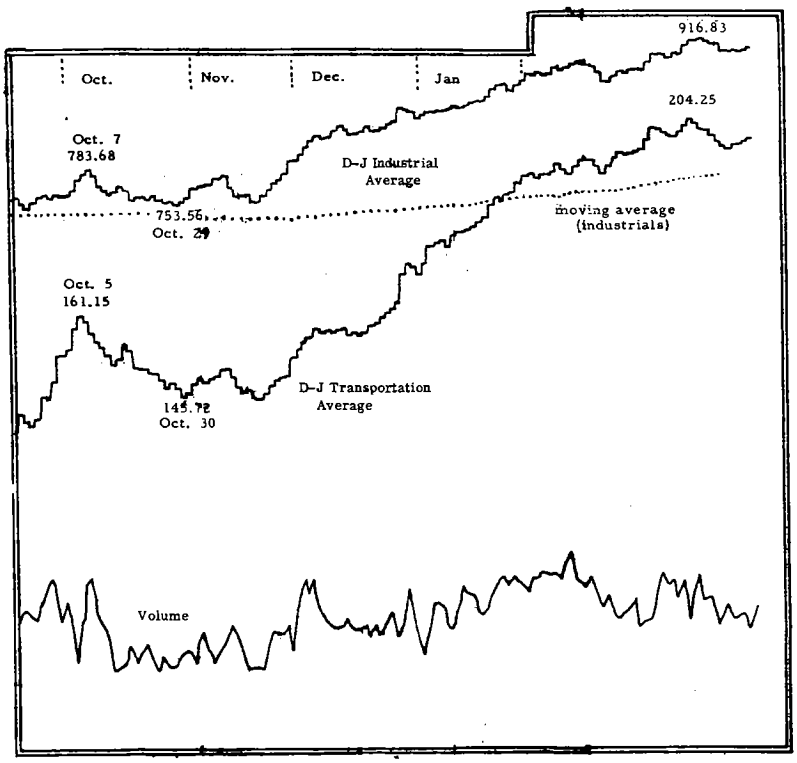
April 2, 1971 Letter 492

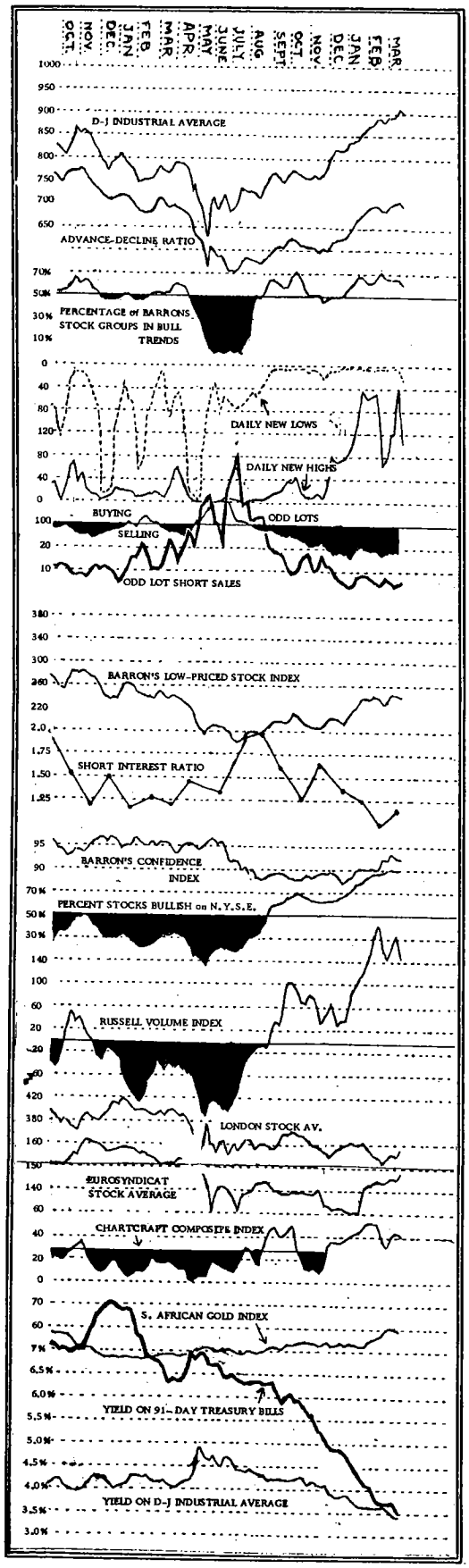
THE PICTURE: A few months ago I discussed Mr. Arthur Okun's "Discomfort Index", which is an index whereby this well-known economist measures the relative discomfort of the American consumer. The Index is of very simple construction: it is the sum of the rate of rise in the consumer price index (the inflation rate) and the unemployment rate.

Now it's a strange thing, but there was a time in this country's history when, if the unemployment rate went up, the inflation rate would go down. This was in the old days of the free, supply-demand economy. A recession would hit, unemployment would rise, people would stop buying, and prices would start tumbling. The worse the unemployment, the lower would go prices. In those days, you could literally "feel" the forces of correction doing their correcting.

Not so today. With the rise of the powerful unions, unemployment can surge, but wages will not budge downward. In fact, the Administration is now experiencing the uncomfortable problem of widespread unemployment together with continuing inflation. Either phenomenon is calculated to put pressure on the Administration during the 1972 elections. Together, they constitute a giant headache.

Mr. Burns of the Fed seems to want some kind of price controls, plus tax credits or incentives to stimulate business (which he knows full well now needs something akin to stimulation). But Mr. Nixon and budget director Shultz are taking a consistent stand against price controls, and they are still hoping that somehow the inflation issue will go away. Also, of course (and understandably), Mr. Nixon hesitates to slap on controls in the face of the huge organized labor vote in this country. So the Administration policy continues





to be "hands off", and business, knowing this, goes blithely along, handing out the periodic whopping wage increases that are forcing prices higher and higher.

A few subscribers have written over the past week to state that they think I am being too harsh with the Administration. Well, if it makes them feel any better (or it makes me appear any fairer), I was harsh with the Eisenhower, the Kennedy, and the Johnson Administration. I thought that Ike was a "leave it alone" President, riding a bull market boom for the most part; I thought the country would have been in a mess had Mr. Kennedy lived a year longer (Wall Street was frightened to death of him); I thought Johnson's handling of the Vietnam War was unprincipled, and I don't think Richard Nixon has the vaguest idea of what he is doing when it comes to the U.S. economy.

Maybe the trouble is that U.S. Presidents are so eager to run for two terms that they'll do anything the first term, just so long as they get in for the second period of glory. Why in heaven's name these gentlemen are so eager for that second term I'll never know. Sometimes I think we should put them in for one six-year term with the stipulation that they are on their honor to do their best for the nation and the devil with politics, rather than allowing them to manipulate the economy towards the voting-express (while hoping somehow to keep the pieces together as a present for the succeeding President, whoever he may be).

I thought Mr. Nixon was right when he ran on an anti-inflation ticket, and I thought he was wrong when he switched to the inflation-let's win the 1972 election track. But in the end I believe that the course of history will prove (as it always has in the past) that galloping inflation leads to lower corporate profits, a collapse of the currency, and finally a collapse of the economy and an ouster of the current party-in-charge. To me it isn't a matter of "whether", it's a matter of timing.

Timing is alot more difficult these days than it used to be. Cycles of boom now extend beyond anything hitherto believed possible. The fact is that this bear market has now consumed five years, and the Dow is still only 100 points under its 1966 peak of 995.15. The rabbits-in-the-hats are proving harder and harder to find, and each new rabbit seems to be smaller and feebler than the previous one. But the rabbits do keep appearing, and the forces of the bear are still being fended off.

Meanwhile, if the economy doesn't pick up it seems that the next Administration try will be for some kind of a tax cut, this with a programmed $11.6 billion deficit already built into the budget, and business already failing to produce the needed revenue to hold the 1971-72 deficit to $11.6 billion. I suppose the final act could be a Federal law forcing us all to clean out our savings accounts and spend the proceeds within 30 days, but anything as outlandish as that could be months and months away.

Incidentally, the full deficit for the fiscal year 1970-71 has not been tallied (the year ends June 30), but already it has climbed above $19 billion (see attached news clip). As far as the 1971-72 budget is concerned, the new social security increases will add about $3.5 billion to the already programmed $11.6 billion deficit, and I would guess that the final deficit for 1971-72 could end up far above $25 billion.

FEDERAL DEFICIT FOR 1971 PASSES $19 BILLION MARK

WASHINGTON (AP)—The federal deficit for the current fiscal year passed the $19 billion mark in February, the government reported Thursday.

For the first eight months of the financial year that ends June 30, the government said the deficit now stands at $19.379 billion.

President Nixon has estimated the fiscal 1971 deficit at $18.6 billion.

In February, the government rang up a $1.4 billion deficit in its operations.

For the first eight months of the fiscal year the government has taken in $118.4 billion and spent $137.6 billion, the Treasury Department report said.

On Wall Street, the stock market has been trying to take the measure of one of the most confusing periods in modern history. On March 16 the Transportation Average struck a recovery peak of 204.25. Two days later, on March 18, Industrials struck their own recovery high of 916.83. The market suddenly weakened over the next few days, and on March 22 the Industrials sank briefly below the 900 level, touching 899.37 on March 24. The comparable low for the Transports was 197.84.

A little rally pushed the Averages upward again with Industrials settling in the 903 area on March 26 and 29. Volume on this rally (see chart, page 1) dropped to the lowest level since December. It is possible that the low volume on the rally indicated an exhaustion of buying power. If so, the test will come if the two Averages violate their lows of 899.37 and 197.84 respectively. I would say that a breaking of those levels with volume increasing could be the first sign of potential trouble ahead. And that's where we stand as of this writing.

STOCKS: If one glances through the front of the M.C. Horsey stock chart book (which has monthly entries), you will note that 30 stock groups are charted, each from 1953 to date. These comprise all the famous Barron's stock groups (retail merchandise chains and investment holding companies are omitted). Last week I went through all of these groups noting which groups had recovered half of their 1965 to 1970 bear market losses (during the 1970-71 recovery), and which had not.

The results were rather surprising, and they may tell us something about this bear market retracement. Of the 30 groups shown, only 16 had recovered 50% or more of their 1965-70 bear market losses while 14 of the groups had failed to recover as much as half their previous losses.

My conclusion is that the 1969-70 rise in the Dow has hidden a great deal of bear market agony, and this is probably one of the main reasons why the public (which is still locked in with many major losses) has never regained its old fervent, speculative spirit.

David L. Babson, one of the deans of finance, put the matter rather succinctly in a recent newspaper column. "A frequent comment is: 'It's doubled since last June!' This sounds great. But most people have either forgotten, or just don't realize, that these 100% rebounds make up for only a small part of the horrendous losses incurred by those who bought speculative stock several years ago.

"Thousands of issues plunged 80% or more in 1969-70. So even if a stock, after falling, say from $50 to $10, has now doubled back to $20, it still shows an overall decline of 60%."

Groups, by the way, which have failed to recoup even half of their bear market losses are: Air Transports, Autos, Aircraft, Chemicals, Farm Equipment, Machine Tools, Machinery, Non-Ferrous Metals, Paper, Rail Equipment, Television Stocks, Rubber Stocks, Textile Stocks, Steel & Iron.

A glance over the list of groups which have been laggards on this bear market (upward) correction shows that with the exception of Television, every group is a "heavy goods" or capital spending-oriented group, the kind that tends to put impetus behind a boom-recovery. My conclusion here is that there is not going to be any capital goods boom coming up to lead the economy into an important expansion phase. And it is well to remember that every boom period since World War II has been led by an expansion in capital goods spending. In other words, this is one more reason why our Washington economists are frustrated by the relative "sluggishness" of the economy following the 1969-70 recession (which they now announce is "over").

Finally, here is another incredible fact as this bear rally sucks the unwary into its vortex. The N.Y.S.E. has announced that the number of individual stockholders grew to 31.9 million in 1971, a record high. This means that of a population of around 200 million in the U.S., we now have 31.9 stockholders or almost one out of every seven men, women and children. What the stock market does now is more important than ever.

MORE ON GOLD: In Letter 491 I presented some of the problems connected with the current U.S. deficit-inflation policy. I stated that if this policy continues (and nothing so far suggests that it is not) Europe would be forced to move towards building up their gold-to-foreign exchange ratios, which would mean getting rid of dollars and buying gold.

Over the year ending February, 1971, the U.S. lost 22% of its earned reserved, and we must now face the incredible fact that Germany has $16.5 billion in reserves compared with $14 billion in reserves owned by the U.S. Last week it was disclosed that Germany has a claim on $500 million in U.S. gold, and when the story of a Germany gold purchase broke out in the New York Times and the Los Angeles Times (see news clip) Treasury officials denied that the Germans had purchased the gold or at least stated that the story was premature.

As of this writing, the U.S. gold reserve position is $11 billion. If the Germans purchase the $500 million in gold, the U.S. gold reserve will be $10.5 billion, just one half billion from the

Germany Buys $500 Million in U.S. Gold

BY JOE ALEX MORRIS JR.
Times Staff Writer

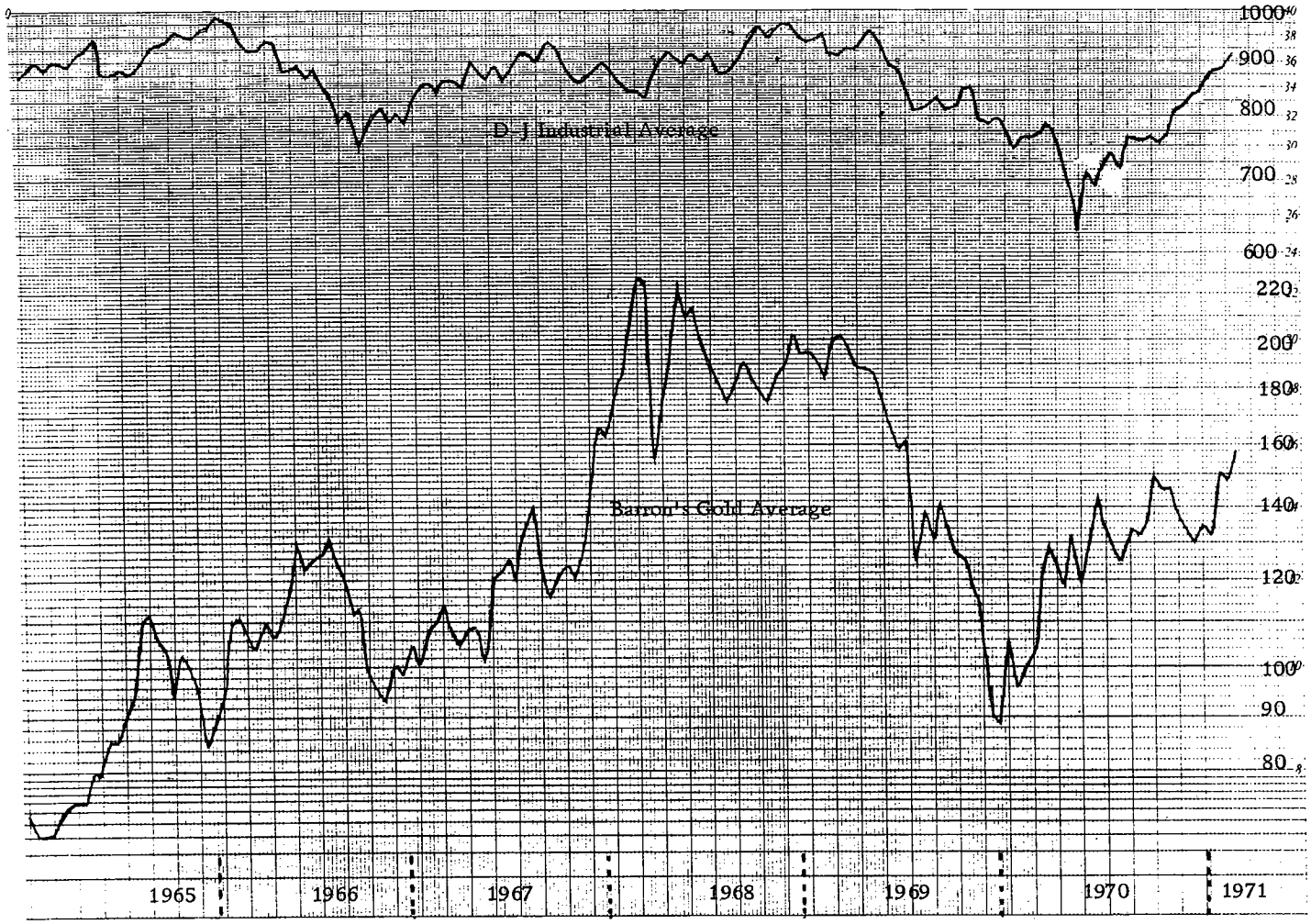
BONN—West Germany has arranged to buy $500 million worth of gold from the United States to counteract the flood of dollars pouring into the country, the federal bank confirmed here Thursday.

The bank called it a quasi-repurchase, pointing out it has sold the same amount of gold to the United States shortly after the mark was revalued in late 1969.

The recent inflow has been caused by persistent high interest rates in West Germany. The discount rate is now at 6%, well above American levels.

The Germans are reluctant to lower the rate because they feel it will work against the gradual cooling off of the economy which is now under way. But one result has been a renewed flow of money into the Federal republic, which two weeks ago reached $660 million on one day.

Last Wednesday, the traditional day for large currency transactions, the figure was only $60 million. But the federal bank's ratio of dollars to gold is now 5-to-1, considerably higher than the 3-to-1 ratio considered to be comfortable by West German bankers.



critical $10 billion level, below which the rumor has it, the U.S. will refuse to sell gold.

It seems to me that a gold run is quietly building up. In the last Letter I noted that the Dutch and the Swiss have recently purchased gold from the U.S. Now it appears that Germany wants a large chunk of gold, and it is rumored that Japan is in the wings. No one knows which other countries want to swap dollars for gold, but if the facts were known I have no doubt it would be frightening.

Frankly, I don't know how a gold embargo can now be put off. It would not surprise me if an actual date had been already set by the U.S. It could be this weekend, Easter weekend or any time soon. But the figures are clear enough, and I believe that Europe is growing nervous to the point of hysteria regarding their sky-high pile of dollars, all backed by only $11 billion in U.S. gold (which will be totally unavailable in case of an embargo).

In view of all this, I thought a study of Barron's Gold Group Index vs. the D-J Industrial Average would be interesting. This chart (above) covers the period of 1965 to the present, and the chart is drawn to semi-logarithmic scale, so that percentages of movement is shown. A 40% rise on this chart will be exactly double the vertical distance of a 20% rise.

In January, 1965, the Gold Average was 74 and the Dow was 869. If one had purchased assorted gold shares and held them to the present (Barron's Gold Average is now 158) one would show a 113% increase in one's money. The increase in the Dow since January, 1965, has been about 4%.

If one had purchased the assorted golds in February, 1966, when the bear market began (gold index was 111) one would now have an appreciation of 42% on one's money. Against this, the Dow shows a loss of 9%.

The long-term trend of the Gold Group has been up, and since 1963 the rising trend has been steeper. The 1968-69 break in the price of gold shares was severe, resulting in the drop shown on the chart from 231 to 89. The rise since the 1969 low has taken the Gold Group within a fraction of the 160 level (the Group is now 157.29), and 160 represents the halfway level of the entire 1968-69 decline.

My guess is that once the Gold Group moves above 160, it will start its assault on the 1968 high again. I recommended purchases of gold shares all during 1970 when I felt that the golds were in a basing area. I would consider any purchase of gold shares while the Barron's Group Average is under 160 to be advantageous.

Most of my subscribers already own gold shares. For those who do not I recommend Dome Mines, Campbell Red Lake, and Homestake. I also like American-South African which is a holding company for S. African gold shares. Of the S. African shares themselves, I like Western Deep Levels, President Steyn, Western Holdings, Free State Geduld, Kloof, Blyvoors, Welkom and West Driefontein.

QUESTIONS: In the 14 years in which I have been writing these reports, I have never been so deluged with questions from readers. The obvious conclusion is that there has never been such consternation and confusion. I cannot possibly answer all the letters, but I will try to answer some of the most constant questions here.

Q: Would an embargo and a rise in the dollar price of gold drive stock prices up or down?
A: Theoretically, a rise in the price of gold (if executed along multi-nation agreement lines) would not effect prices. It would merely mean that the world's gold reserves would be arbitrarily valued upward. But if the U.S. embargoes gold, this would be an act tantamount to saying, "Look, we know there are about $40 billion overseas, all claims or potential claims on $11 billion of our gold. We can't pay off, and that's that. We're terminating gold sales". No one knows the psychological repercussions that such an act would set off. My own guess is that a certain percentage of dollar holders would panic, and that they would get rid of their dollars wherever they could. This would mean a plunge in the value of the dollar on the international markets, and a chaotic condition in world trade. Such an interruption could well set off the sparks which would start this market down into a massive bearish plunge.

To me, the crucial issue is that all this would be occurring within a primary bear market. Or if one wishes to take a different viewpoint (one hold by the authoritative Bank Credit Analyst of Canada), it would occur near the top of a "super-cycle". In the latest report, the Bank Credit Analyst concluded that the cyclical money trends are bullish, but that we are facing "once-in-a-lifetime risks, stemming from a broad liquidity squeeze throughout the economy.....".

Q: Why should I hold Treasury bills yielding only 3.5% when I can buy bonds yielding a good deal more or place my money in a savings bank?
A: I feel that at this state of the game, the greatest safety is the best policy. There is no perfect safety, only levels of safety. There is great safety in holding gold bullion, but this is illegal for U.S. citizens. Gold mining shares are not illegal, and I have advocated putting up to 20% of assets in these shares. True, the U.S. Government could confiscate these shares, they could do anything, but this is a chance we take. Treasury bills are the first call on the U.S. Government. The U.S. Government could become insolvent, anything could happen, but if Treasury bills are not paid off, the dollar would not be worth a thing, and who knows what would happen to real estate, businesses, bonds or anything else. Therefore, Treasury bills are an imperfect repository, but they are the best thing offered in this country.

Q: Why not hold a stable overseas currency such as Swiss Francs?
A: No objection, but if there is a gold embargo, there might also be severe restrictions on currency exchange, and you might have to go to Switzerland to spend your money. That doesn't appeal to me. So the foreign currency idea is a good hedge, but not perfect for American citizens.

Q: Why not keep my money in the stock market, and just let it ride with the fortunes of the market? Isn't that as safe as anything else?
A: The lessons of history indicate that holding common stocks during a primary bear market proves ultimately to be disastrous. History underscores that word ultimately. We have to have some sane policy in dealing with our assets, and the policy I follow is the one dictated by Dow's Theory. The Theory doesn't tell us that we'll go broke holding common stocks during the first year of a long bear market or the third or the fifth. It says that if we adhere to a policy of fighting the bear, we'll go broke. Those who have held Emerson Electric through this bear market are ahead, so far, those who have held GM have still not recovered even half their bear market losses, those who held Lockheed wish they had never heard of Wall Street. My guess is that as the bear market progresses, more and more people will end up in the third category. But there will always be a few exceptions.

Q: Won't the tremendous institutional participation in the market prevent a collapse?
A: There are 32 million individuals in the market, but institutions are now responsible for 70% of the action on the N.Y.S.E. The institutions have now taken the place of the public as far as the trading is concerned. Institutions are run by men, and the majority of men tend to be wrong on the major moves in Wall Street. Thus it appears that there will be the "professional-type" institutions and the "odd-lot type" institutions which will participate in the action. When the turn comes, a small

percentage of the institutions will be right, and the great majority will be wrong. The record of the funds during 1969-70 was very bad, for the most part. In view of that, I cannot understand why so many people continue to believe that the institutional domination of Wall Street at this time is any great boon.

Q: What is the major difference now, with institutions dominating Wall Street and in former days, when individuals dominated Wall Street?

A: The men who run institutions are not investing their own money. They are very performance minded, and they are trained to move quickly. This means that the action of the market is faster, more insistent, and less prone to minor corrections at this time. When the 1969-70 decline seemed exhausted, the institutions piled in with a vengeance. The funds loaded up, and their cash is now only 7% of total assets. If the institutions decide that the top is here, that the best has been discounted, I would expect them to exit with the same speed. That could provide a downward movement in this bear market which will be historic in intensity and violence. The little investor and the individual will be as chaff in the wind when that movement gains momentum.

Q: What worries you most about the period ahead, assuming your gaint bear market collapse thesis comes to pass?
A: Without a moment's hesitation, I would say the fear that Americans will passively give up their freedom. History shows that the majority will give up almost any personal liberty in the name of safety. And history shows that in times of great stress, people turn to the man of the Government which will promise the most (but somehow those promises always carry the stipulation that this or that freedom must be given up "for the duration of the emergency"). Stanley Baldwin wrote, "One of the weaknesses of a democracy, a system of which I am trying to make the best, is that until it is right up against it, it will never face the truth". Reluctantly, I agree. As I see it, the American people are now at the crossroads, and it will take great bravery and sacrifice to stand up for the truth over the period ahead.

It is probable that no area is so little understood in this nation as the one dealing with economics and finance. Already Americans have given up their good, precious-metal coinage, they have given up the gold which used to guarantee the worth of every dollar, they have given up the stability of their money as inflation wipes out chunks of their savings month after month, they have passively participated in an undeclared war which is already the longest (and one of the most expensive) in U.S. history, they are passively allowing the Government to bankrupt itself as it sinks deeper and deeper into debt, mortgaging the future of untold generations to come.

Frankly, at this point I don't know what the answer is. Perhaps the whole experience is simply going to be a great and awful lesson for future Americans who will have to carry on while rectifying the mistakes of our leaders today. Perhaps it is the final test (which we are probably failing) before a descent into a modern "Dark Age". Or perhaps it will be the fiasco which will produce new values and new concepts whereby future, and more enlightened Americans will love and live in peace and happiness. I don't know. I wish to God I did.

ODD-LOT SHORTS: I always become interested in an indicator when it moves to an historical extreme. Right now, the odd-lot short sales appear to be in such an area. The accompanying chart shows the Dow Industrials and the Quote odd-lot short index from 1964 to date (chart courtesy of Quote Digest, 403 N. Main, Wichita, Kans. 67202). Note that the odd lot short index (inverted) is now at its lowest area since 1965 (with the exception of one, very low-shorting area towards the end of January, 1969).

The Index indicates that the odd-lot short seller is now extremely skeptical of the possibility of a profitable "play" on the downside. Historically, it may be said that the odd-lot shorter is a timid, almost cowardly creature. He seldom jumps the gun on a decline, but waits for a decline to get underway before putting out his shorts. This means that a rise accompanied by high odd-lot shorts is usually in good shape (not near topping-out area). Conversely, an area of very low odd-lot shorting (such as now) can be a dangerous one.
In other words, the absence of odd-lot shorts does not guarantee a decline, but it allows for one. As seen on the chart, the odd-lot index certainly allows for a decline at this time. The odd-lot shorts are more reluctant to be on the downside now than at any time in the past six years.